IN THE HIGH COURT OF GUJARAT AT AHMEDABAD

INCOME TAX APPLICATION No 269 of 1999

For Approval and Signature:

Hon'ble MR.JUSTICE B.C.PATEL and
MR.JUSTICE P.B.MAJMUDAR

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1. Whether Reporters of Local Papers may be allowed to see the judgements? : NO

2. To be referred to the Reporter or not? : NO

3. Whether Their Lordships wish to see the fair copy of the judgement? : NO

4. Whether this case involves a substantial question of law as to the interpretation of the Constitution of India, 1950 of any Order made thereunder? : NO

5. Whether it is to be circulated to the Civil Judge? : NO

COMMISSIONER OF INCOME TAX

Versus

JYOTI ELECTRIC MOTORS LTD.

Appearance:

MR MANISH R BHATT for Petitioner
MR JP SHAH for Respondent No. 1

CORAM : MR.JUSTICE B.C.PATEL and
MR.JUSTICE P.B.MAJMUDAR

Date of decision: 03/11/1999

ORAL JUDGEMENT

The Commissioner of Income Tax, Baroda being aggrieved by an order made on 9.11.98 by Income Tax Appellate Tribunal, Ahmedabad Bench C (hereinafter referred as the Tribunal) in an application under Section 256(1) of the Income Tax Act, 1961 (hereinafter referred to as the Act) has preferred this application under Section 256(2) of the Act.

The Tribunal hearing the appeal at the instance of Revenue, considered the judgement of this Court reported in CIT Vs. Jyoti Limited in 118 ITR 499 and confirmed the order passed by the Commissioner of Income Tax (Appeals). The Revenue preferred an application for reference which was rejected by the Tribunal and hence the present application is preferred by the Revenue. The following question was raised before the Tribunal for making a reference:-

"Whether, on the facts and in the circumstances of the case, the Income Tax Appellate Tribunal was right in law in upholding the Commissioner of Income Tax (Appeals) order deleting the addition made on account of disallowance of royalty of Rs.11,16,532/- paid to M/s.Jyoti Ltd.?

[2. The law is well settled so far as the payment of royalty is concerned. In the case of Commissioner of Income Tax, Gujarat - IV V/s. Jyoti Ltd, there was an agreement between the assessee-company and the German company clearly indicating that the property in the drawings, designs, etc. was not to pass to the assessee and there was no question of sale of the drawings, designs, etc., by the German company to the assessee. Hence, there was no question of acquisition of assets in the nature of capital by the assessee so far as the drawings, designs, patterns, etc., furnished by the German company to the assessee-company were concerned. The payments which were made by the assessee-company to the German company were undoubtedly in respect of assets of a capital nature, but as they were for the use of those assets only during the period of the subsistence of the licence and the moment the licence came to an end, the assessee-company was no longer entitled to the know-how embodied in these patterns, drawings, designs, etc, the expenditure was considered as of a revenue nature and not of a capital nature. There was an agreement between the assessee company and the German Company indicating that the property in these drawings/designs etc. was not to pass to the assessee & there was no sale of the drawings/designs etc. by the German company to the assessee company. Thus there was no question of acquisition of assets.

3. The Apex Court in the case of Commissioner of Income Tax Vs. CIBA of India Ltd, 69 ITR 692 has held that the payments were of revenue nature and not of capital nature because the knowledge of technical knowhow was placed at the disposal of the Indian company for a

short duration. At the end of the period of the licence, the Indian Manufacturer could not utilise that knowhow any further.

4. A similar question was raised before this Court in CIT Vs. S.L.M. Maneklal Industries Ltd. 107 ITR 133. The Court pointed out that to decide whether there is a sale or not, the main point for consideration is that whether the property in the workshop drawings, etc., passed or, was in contemplation to pass. Normally, when a person purchases any property, then on a complete sale, he gets full title over the property and he can deal with the purchased articles in such manner as he likes. There were restrictions set out in clause (7)(8)(9) and (12) in the agreement which hedge in the rights of the assessee-company with regard to the workshop drawings, etc. in the case of CIT Vs. SLM Maneklal (Supra). Under these clauses, the assessee-company, having received the supply of the workshop drawings, etc., could only utilise them for the purpose of the licence and not for any other purpose. It could neither assign its rights in connection with these workshop drawings, etc., or the know-how, nor could the assessee-company at any time deviate from these workshop drawings, etc., nor could it make any alterations, and if any deviations or alterations were contemplated, prior approval of SLM was necessary. Even, if the assessee-company proposed to incorporate any improvements in the design, the benefit of those improvements had to be made to SLM. Clause (9) clearly stated that the drawings and other technical information supplied by SLM was to be used only for the scope of and during the continuance of the agreement. On these facts, the Division Bench held that the expenditure incurred by the assessee for workshop - drawings, patterns, for the manufacture of certain machinery, was a revenue expenditure and allowed as a revenue expenditure.]

5. In the present case, the copy of the agreement makes it very clear that an agreement was executed on 25.3.83 for the supply of technical knowhow for the purpose of manufacture of hydrolic equipments. It was necessary to permit the user to make the use of a trademark and on agreeing to the covenants, the Registered Proprietor agreed to permit the user to make the use of the said trademark. Clause 3 of the agreement if read, becomes clear that the user was required to follow the directions, standards and specifications prescribed by the Registered Proprietors in the course of manufacture and/or sale of hydrolic equipments and user was permitted to sell in the market hydrolic equipments under a trademark only if the equipments were

manufactured as per standard and quality laid down by the Registered proprietors. Reading the clause of the agreement it becomes clear that with a view to maintain the standards, the user was required to allow the registered proprietors or its delegates to inspect the goods, user's methods of manufacture on the premises of the user at any time. The agreement further indicates that the trademark was not to be used in any manner whatsoever which may jeopardize the significance of the distinctiveness or validity of the said trademark. The user was required to clearly describe and indicate that the trademark is of the registered proprietor and that it was being used only with the prior permission of the Registered Proprietors. Reading clause (11) it becomes clear that it was terminable on the expiration of 3 months from the date of dispatch of notice or any later date mentioned therein. Thus it was not for a fixed period and it was open for either party to terminate the agreement. Reading the entire agreement one has to decide whether the amount spent could be described as Revenue Expenditure or capital expenditure.

In a free market, where there is a competition trader would be interested in finding out more and more buyers. Considering the reliability of the product, the consumer would buy the article manufactured by a company having a trademark giving assurance about the nature, quality and standard of the product. Articles manufactured by several companies of similar nature would be available in the market. A consumer, on account of experience of his own, or of other user known to him or acquiring knowledge about the article through literature pertaining to the article or having an occassion to compare the literature of other similar articles judging the suitability of the article, will look for the article having a trademark. The Company/person obtains trademark after following the procedure in accordance with law. The trademark has a value as the manufacturer, manufactures the goods of a particular quality and standard. The registered proprietor of the trademark under an agreement authorises the use of its trademark and the registered proprietor is required to see that the goods manufactured are of the standard as required and the quality as required so as to make acceptable to the consumers.

The registered proprietor of a trademark has acquired reputation because of the quality and standard of the product. The Company having a trademark has to see that article manufactured by the company is of a particular standard so as to see that in the market its

goods are not only competing with others but are accepted favourably by the buyers because of the nature, quality and standard. This can be achieved by a technical know-how for the purpose of manufacturing the articles with the standard and quality. With a view to ensure the maintenance of the standards, the user was required to permit the proprietors or its delegates to inspect not only the goods manufacturered but also the goods and the method of production. Trademark by now has acquired a special feature and is a property of the owner. The owner permits others to use the trademark with a view to earn money for which he has to see that goods manufactured are of a particular standard and quality. It is known that the manufacturer can manufacture the article available in the market, but the article having particular brand name being acceptable to the consumers, the manufacturer for the purpose of large business would enter into an agreement so as to manufacture goods of particular quality and standard. That can be achieved only if technical know how is acquired. Payment is for the technical knowhow. A trademark is the acquisition of property right. After use of technical knowhow for the product and experience too the same is acquired. It is used by others with permission of the proprietor for improvement in quality of the products which ultimately facilitates the trading operations enabling to conduct business with efficiency.

Apex Court in the case of EMPIRE JUTE CO. LTD. VS. C.I.T. (S.C.) reported in 124 ITR 1, pointed out that the expendtiure would be on revenue account despite the advantage that may endure for an indefinite future.

> "What is material to consider is the nature of the advantage in a commercial sense and it is only where the advantage is in the capital field that the expenditure would be disallowable on an application of this test. If the advantage consists merely in facilitiating the assessee's trading operations or enabling the management and conduct of the assessee's business to be carried on more efficiently or more profitably while leaving the fixed capital untouched, the expenditure would be on revenue account, even though the advantage may endure for an indefinite future."

The Apex Court in the EMPIRE JUTE case (supra) also quoted with approval, the following observations made in the case of Hallstrom's Property Ltd. vs. Federal

Commissioner of Taxation (72 CLR 634) (at page 13 of 124 ITR):

"What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured, employed, or exhausted in the process." The question must be viewed in the larger context of business necessity or expediency. If the outgoing expenditure is so related to the carrying on or the conduct of the business that it may be regarded as an integral part of the profit earning process and not for acquisition of an asset or a right of a permanent character, the possession of which is a condition of the carrying on of the business, the expenditure may be regarded as revenue expenditure."

Coming to the facts of the present case from the agreement, it is clear that the assessee entered into an agreement for the purpose of enabling the assessee to carry on its business more efficiently and more profitably. So far as fixed capital is concerned, it has remained unchanged. The use of the trade mark under an agreement did not create any asset. The amount of royalty to be paid by the assessee was dependent on the sale. It did not confer any right of a permanent nature in favour of assessee. It is also required to be noted that the agreement is terminable by giving three months notice. Use of trade mark enabled the assessee to confer on the product the advantage of better quality and maketability. The payment of royalty, thus was in the course of profit earning process and there was no question of acquisition of an asset or a right of a permanent character.

In ALEMBIC CHEMICALS WORKS CO. LTD. VS. C.I.T. (1989) 177 ITI 377 (SC), there was an agreement to supply to the assessee requisite knowhow to achieve substantially higher levels of performance of production. The Apex Court held that the improvisation in the process and technology employed was supplementary to the existing business and the agreement pertained to a product of the assessee's established business and not to a new product and that clearly indicated that what was stipulated was an improvement in the operations of the existing business and its efficiency and profitability - not removed from the area of day to day assessee's established enterprise.

In CIT vs. AVERY INDIA LTD (1994) 207 ITR 813 (Calcutta High Court) and in the case of COROMANDEL FERTILIZERS LTD. vs. C.I.T. (1984) 149 ITR 546, the Courts pointed out that it is unrealistic to say that technical knowhow is an advantage of enduring nature.

In case of CIT Vs. Ashok Mills Ltd. reported in 218 ITR 526, the Division Bench of this Court had an occasion to consider the case where there was a user of the trademark "Teblized." The Tribunal in that case held that the royalty paid by the user of the trademark is revenue expenditure, allowable as revenue expenditure. The Court demonstrated as to how the views expressed by the Tribunal are acceptable.

5. Mr.Naik, Ld. Counsel appearing for the Revenue submitted that the Apex Court has taken a different view in case of Jonas Woodhead and Sons (India) Ltd. V. Commissioner of Income-Tax reported in 224 ITR 342. The Apex Court considered the various jugements and has pointed out as under:-

> "It would thus appear that the courts have applied different tests like starting of a new business on the basis of technical know-how received from the foreign firm, the exclusive right of the company to use the patent or trademark which it receives from the foreign firm, the payment made by the company to the foreign firm whether a definite one or dependant upon certain contingencies, the right to use the technical know-how of production or the activity even after the completion of the agreement, obtaining enduring benefit for a considerable part on account of the technical informations received from a foreign firm, payment whether made "once for all" or in different installments co-relatable to the percentage of gross turnover of the product to ultimately find out whether the expenditure or payment thus made makes an accretion to the capital asset and after the court comes to the conclusion that it does so, then it has to be held to be a capital expenditure. As had been held by this court and already indicated in Alembic Chemicals Works case (1989) 177 ITR 377 no single definite criterion by itself would be determinative and, therefore, bearing in mind the changing economic realities of business and the varieties of situational diversities the various clauses of the agreement

are to be examined."

In the case of Jonas Woodhead and Sons (India) Ltd (Supra), the High Court considered different clauses of the agreement and came to the conclusion that a new business was set up under an agreement with the foreign firm which had not only furnished information and the technical know-how to render valuable service in setting of the factory itself, but after the expiry of the agreement, there was no embargo on the assessee to continue to manufacture the product in question.

6. In the instant case, use of trademark was by way of permissive user on certain conditions and on termination of the agreement, the assessee cannot use the trademark resulting in embargo on manufacture of the product with trademark. Thus the expenditure incurred for acquiring technical know how for a limited period or acquiring technical know how for improvement in quality of products facilitating the trading operations enabling to conduct the business with efficiency, ultimately resulting in earning of more profits or the expenditure is so related to the carrying on the business or the conduct of the business that be regarded as an integral part of the profit making process and hence should be regarded as revenue expenditure.

With regard to royalty, the Asstt. Commissioner of Income Tax disallowing the royalty payment of Rs.11,16,582/- in para 8 observed as under:-

"8. Disallowance of Royalty Payment:-

It is observed that in this case, year after year, royalty payment made to Jyoti Ltd. is being disallowed for reasons given in orders of earlier years. It is a fact that this royalty payments are allowed by all appellate authorities including CIT(A) ITAT, and High Court. However, I am given to understand that the assessee as well as department have agreed that both the parties will abide by the decision of CIT v/s. Jyoti Ltd. reported at 118 ITR 499. As there is no remedy for the department if no disallowance of royalty payment is made in the assessment order and if the Supreme Court decision is not received within the period of four years so as to rectify the assessment order u/s. 154 of the Act and hence as a measure of precaution, dis allowance of royatly payment is made without disrespect of the judgement of the Hon'ble Guj.High Court and the understanding arrived at."

The Commissioner of Income Tax (Appeals), hearing the appeal allowed the claim of assssee and reversed the aforesaid finding recorded by Asstt. Commissioner of Income Tax. The Commissioner hearing the appeal in para 6 of the order specifically held that the issue is covered in favour of assessee by the decision of CIT (Appeals), Tribunal and High Court.

7. In view of what we have narrated hereinabove, the Tribunal has rightly approved the order of CIT (Appeals) deleting the addition made on account of disallowance of royalty paid to M/s. Jyoti Ltd. and no interference is called for. Hence the application stands dismissed. Rule discharged with no order as to costs.

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